



Prudential Practice Guide

SPG 511 – Remuneration

November 2013


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About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

Prudential Standard SPS 510 Governance (SPS 510) sets out APRA's requirements in relation to the governance of an RSE licensee. This PPG aims to assist an RSE licensee in complying with remuneration requirements contained in SPS 510 and, more generally, to outline prudent practices in relation to certain remuneration matters.

For the purposes of this guide, and consistent with the application of SPS 510, 'RSE licensee' has the meaning given in the *Superannuation Industry (Supervision) Act 1993 (SIS Act)*.

Subject to the requirements of SPS 510, an RSE licensee has the flexibility to configure its remuneration arrangements in the way most suited to achieving its business objectives. Not all practices outlined in this PPG will be relevant for every RSE licensee and some aspects may vary depending upon the size, business mix and complexity of the RSE licensee's business operations and the diversity of the superannuation industry, in particular the absence of ultimate shareholders in some sections of the industry.

RSE licensees that operate within corporate groups regulated by APRA and/or RSE licensees that have complex remuneration structures should also refer to *Prudential Practice Guide PPG 511 Remuneration (PPG 511)*, which provides guidance to other industries regulated by APRA.

Introduction

1. RSE licensees are required to perform their duties in the best interests of beneficiaries and to exercise the same degree of care, skill and diligence as a 'prudent superannuation trustee' would exercise in relation to an entity of which it is a trustee and on behalf of the beneficiaries of which it makes investments.¹
2. SPS 510 includes a range of requirements relating to remuneration arrangements within the RSE licensee's business operations. These requirements support the alignment of prudent remuneration practices with the best interest duties of the RSE licensee.
3. In September 2009, the Financial Stability Board (FSB) issued *Principles for Sound Compensation Practices – Implementation Standards* (Implementation Standards²). An RSE licensee may have regard to the FSB's Principles and Implementation Standards for further guidance in addressing APRA's remuneration requirements.
4. An RSE licensee's business objectives with regard to remuneration are likely to be wider than those discussed in this PPG. For example, remuneration objectives are likely to relate to attracting and retaining staff. APRA's remuneration requirements and guidance relate to managing or limiting risk incentives associated with remuneration. They are not intended to affect business decisions regarding pay levels or limit innovative methods of rewarding staff, provided such measures do not compromise the requirements of SPS 510.

Governance of remuneration arrangements

5. SPS 510 sets out minimum requirements that an RSE licensee must satisfy in the interests of promoting effective governance. Remuneration needs to be properly considered in order to mitigate the risks that may arise from poorly designed remuneration arrangements.

¹ Refer to s. 52(2)(b) and s. 52(2)(c) of the *Superannuation Industry (Supervision) Act 1993*.

² www.financialstabilityboard.org

6. The Board has ultimate responsibility for the sound and prudent management of an RSE licensee, including its remuneration arrangements. Although SPS 510 requires the establishment of a Board Remuneration Committee, the Board retains ultimate responsibility for remuneration. In dealing with matters relating to remuneration, the Board would be expected to ensure that executive directors are not placed in a position of actual or perceived conflict of interest. SPS 510 requires the risks associated with remuneration to be managed in a manner that supports the RSE licensee's risk management framework. An RSE licensee's Remuneration Policy is one element of this framework.

Board Remuneration Committee

7. APRA recognises that an RSE licensee may have a Board Committee, other than a Remuneration Committee, that undertakes the functions of a remuneration committee. This is acceptable providing the Committee satisfies the requirements in SPS 510. In such cases, the functions required to be undertaken by the Board Remuneration Committee would need to be formalised in the Committee's charter or terms of reference.
8. SPS 510 provides for an RSE licensee that is part of a corporate group to be covered by a group Board Remuneration Committee. In such circumstances, the Board of the RSE licensee will need to ensure, and be able to demonstrate to APRA, that the recommendations made by the group Board Remuneration Committee are appropriate for the RSE licensee. For this purpose, APRA expects the Board to have direct access to the group Board Remuneration Committee and the ability to amend any recommendations of the Committee where the Board considers it appropriate to make such amendments for the RSE licensee. Where a group Board Remuneration Committee exists, and is used by a subsidiary Board in the place of its own Board Remuneration Committee, any references to 'Board Remuneration Committee' in this PPG should be read as 'group Board Remuneration Committee'.

9. SPS 510 requires the Board Remuneration Committee to periodically review the Remuneration Policy, to ensure that it remains appropriate for its intended purpose. As part of this review, the Committee would be expected to identify material deviations of remuneration outcomes from the intent of its policy. The Committee would also be expected to identify unreasonable or undesirable outcomes that flow from existing arrangements. SPS 510 does not prescribe a minimum review period but APRA would generally expect a review of the Remuneration Policy to be undertaken at least every three years.
10. It is important that such periodic reviews extend to the three groups referred to in paragraph 24 of this PPG; non-executive employees with material financial incentives may take actions that are individually immaterial but collectively detrimental to the soundness of an RSE licensee's business operations.
11. SPS 510 also requires the Board Remuneration Committee to make recommendations to the Board on the individual remuneration of responsible persons as defined in *Prudential Standard SPS 520 Fit and Proper* (SPS 520).
12. In addition to making recommendations to the Board on the individual remuneration of certain persons, the Board Remuneration Committee is also required under SPS 510 to make annual recommendations to the Board on the remuneration of all of the categories of persons required to be covered by the Remuneration Policy (other than those persons for whom individual recommendations are required). This will usually require, *inter alia*, the Board Remuneration Committee to make recommendations on the annual distribution of an RSE licensee's or group's bonus pool to the extent relevant to the operations of the RSE licensee.
13. The Board is expected to ensure that the Board Remuneration Committee has the necessary experience and expertise to perform its duties. APRA notes that a variety of skills will be required to ensure sound governance of remuneration matters. Collectively, the Committee would be expected to have experience in setting remuneration and sufficient industry knowledge to allow for effective alignment of remuneration with an RSE licensee's obligations to beneficiaries. The Committee may need to supplement its expertise with appropriate external expert advice.
14. For corporate groups, APRA acknowledges that there will be instances where a person is a 'responsible person' for more than one regulated entity. APRA expects that the remuneration of a responsible person with responsibilities beyond a single institution within a group only needs to be determined once. This may be by a group Board Remuneration Committee as long as the person's responsibilities to the RSE licensee's business operations are adequately considered by the group Board Remuneration Committee.
15. The Board Remuneration Committee may rely on administrative support or advice from internal or external parties when conducting reviews. The Committee, in performing its duties, would typically seek information from relevant internal parties including, but not limited to, those responsible for risk management, human resource management and internal audit. APRA expects the Committee to ensure that there are processes in place to support the management of conflicts of interest when advice from such parties is sought.
16. Effective coordination between a Board Risk Committee, or equivalent group that performs this role, and the Board Remuneration Committee will assist in producing a properly integrated approach to remuneration.

Use of external advisers

17. If a Board Remuneration Committee engages external advisers, SPS 510 requires that the advisers be commissioned in a manner that ensures that their engagement, including any advice received, is independent. The Board Remuneration Committee will need to exercise its own judgement and not rely solely on the judgement or opinions of others.

18. Where a Board Remuneration Committee chooses to seek advice from a third party, there is a potential for conflicts of interest to arise where the third party provides, or may seek to provide, other remuneration advice or services to the regulated institution or its executives. In engaging an adviser, APRA expects the Committee not to engage an adviser who is acting concurrently or has acted recently on behalf of management or of any executive of the regulated institution in relation to remuneration.

Remuneration Policy

19. SPS 510 requires the Board to have in place a Remuneration Policy. APRA expects that the Remuneration Policy will be appropriate to the size, business mix and complexity of an RSE licensee's business operations. It would also be appropriate to the complexity of the remuneration arrangements that it covers.

20. APRA recognises that some RSE licensees have little or no staff other than directors and little or no performance-based components of remuneration. APRA nevertheless expects such RSE licensees to have a written Remuneration Policy, in accordance with SPS 510, that explains the objectives and the structure of the remuneration arrangements. For RSE licensees with little or no staff other than directors, the Remuneration Policy is likely to largely cover service contracts with relevant outsourced service providers of the RSE licensee.

21. The requirements of SPS 510 apply to all forms of remuneration regardless of where or from whom the remuneration is sourced. This includes the remuneration of non-executive directors of the RSE licensee, regardless of whether or not they are remunerated by the RSE licensee or another entity.

22. APRA expects that an RSE licensee would have a clear understanding of the remuneration structures of responsible persons and any other relevant individual and take appropriate action where the remuneration structure is not in line with the RSE licensee's approach to remuneration outlined in the Remuneration Policy. This includes

circumstances where directors are paid by another entity within a corporate group, as well as member and employer representative directors who are remunerated by a nominating body.

23. An RSE licensee that is part of a corporate group can utilise a group Remuneration Policy provided that the group policy as a whole meets the requirements of SPS 510.³ The group Remuneration Policy may need to be adjusted for the RSE licensee if the Remuneration Policy does not address APRA's requirements.

24. SPS 510 requires that the Remuneration Policy cover all persons or classes of person whose actions could put the financial position of the RSE licensee's business operations or its ability to meet the reasonable expectations of beneficiaries at risk. In this regard, APRA has specified three groups for the purposes of the Remuneration Policy:

(a) the first group is 'responsible persons'. These are defined in SPS 520 to include directors, executives and senior managers who make or participate in making decisions that affect the whole, or a substantial part, of the business of an RSE licensee's business operations. RSE auditors and RSE actuaries of the RSE licensee are also defined to be 'responsible persons' but are excluded from this group.⁴ For RSE licensees that are part of a corporate group, 'responsible persons' may be designated as such across a number of entities within the group.

(b) the second group is persons whose primary role is risk and financial control (including risk management, compliance, internal audit, financial control and actuarial control roles). The remuneration of such persons requires special attention because of the potential conflict between their own interests and the interests of executives and others whose financial and risk performance they are required to monitor; and

³ For groups with an overseas-based parent, group policies that do not satisfy the FSB's Principles and Implementation Standards (refer to PPG 511) are unlikely to satisfy APRA's remuneration requirements.

⁴ 'RSE auditor' and 'RSE actuary' have the meaning given in section 10(1) of the SIS Act.

- (c) the third group is all other persons who receive a significant proportion of performance-based remuneration through mechanisms such as bonuses or commissions. These persons may not individually pose a risk to the RSE licensee and/or its business operations but may collectively do so, or affect the ability of the RSE licensee to meet the reasonable expectations of beneficiaries. Therefore, remuneration arrangements for this class are important. APRA envisages that such persons would typically include, but not be limited to, financial market traders, other transaction-oriented staff, commissioned sales personnel, financial planners and intermediaries such as agents and brokers.
25. SPS 510 refers to 'persons for whom a significant portion of total remuneration is based on performance'. The determination of whether or not the performance-based proportion of a person's remuneration is significant will vary according to the context, which will include, *inter alia*, the circumstances of the RSE licensee, the significance of the remuneration to the individual, the role of the individual concerned and the RSE licensee's risk management controls and remuneration practices. APRA expects RSE licensees to undertake their own assessments of significance on the basis of the circumstances and the remuneration arrangements of the RSE licensee.
- Payments to non-employees**
26. SPS 510 requires the Remuneration Policy to cover persons who are not directly employed by the RSE licensee but who provide services to the RSE licensee or any of its RSEs and who may, individually or collectively, be able to affect the financial position of the RSE licensee's business operations or its ability to meet the reasonable expectations of beneficiaries. Such persons may be contractors or persons employed by a related service company within a group or a third-party body corporate.
27. The nature of the engagement of such persons is expected to be addressed in the Remuneration Policy as follows:
- (a) where the RSE licensee contracts with individuals, the payments to these individuals would be expected to conform to the RSE licensee's Remuneration Policy;
 - (b) where the RSE licensee contracts with a related body corporate, persons employed by the body corporate who provide services to the RSE licensee are to be treated as employees of the RSE licensee; and
 - (c) where the RSE licensee contracts with an unrelated body corporate, it is the contractual terms with the body corporate that are relevant, rather than the remuneration of individuals employed or engaged by the body corporate.
28. Where an unrelated body corporate provides services to an RSE licensee, incentive payment structures for such bodies corporate can give rise to inappropriate risk-taking behaviour that is inconsistent with the RSE licensee's risk appetite or obligations to beneficiaries. Outsourced service providers such as investment managers, as well as third-party distribution channels such as brokers, promoters and financial planners, create the potential for members' benefits to be negatively impacted. This highlights the need for careful consideration of incentives associated with financial arrangements made with such parties and the appropriateness of the nature and circumstances of payments made to them.
29. A prudent RSE licensee would ordinarily review service contracts against the Remuneration Policy to ensure that the terms of the service contract align with the Remuneration Policy of the RSE licensee. APRA also expects that an RSE licensee would make an assessment of the service contract to ensure that it considers the terms are reasonable and do not encourage risk-taking at a level that falls outside the risk appetite of the RSE licensee.⁵ Whilst contracts with each

⁵ Refer to *Prudential Standard SPS 220 Risk Management* for requirements relating to risk appetite.

individual unrelated third party may not have a material effect on the RSE licensee's business operations or its ability to meet the reasonable expectations of beneficiaries, those contracts could when considered collectively. Although it may be the case that the business arrangement with each party is not of a material size, prudent practice would require the Remuneration Policy to consider the collective risks associated with such arrangements.

30. An RSE licensee would be expected to ensure that the contract between the RSE licensee and the third party complies with APRA's remuneration requirements. Among other things, contracts regarding third-party sales and distribution activities would be expected to be constrained by the same or similar risk adjustment and deferral arrangements that would apply if this business were undertaken in-house by persons directly employed by the RSE licensee.
31. It is not the case, however, that all third-party contract arrangements will be subject to the Remuneration Policy. APRA recognises that regulated institutions may utilise other processes that address the risks associated with incentive-based third-party payment arrangements. In such cases, where the Board Remuneration Committee is satisfied that these arrangements have been deliberated upon and assessed by the Board Risk Committee or another appropriate Board committee, such arrangements will not need to be covered by the Remuneration Policy. Where this is the case, an RSE licensee is expected to be able to demonstrate that the remuneration requirements in the governance standards are being adequately addressed by those processes.

Adjusting remuneration for risk

32. *Prudential Standard SPS 220 Risk Management* requires RSE licensees to have a risk management framework to identify, assess, monitor, report on, mitigate and manage material risks that may affect its ability to meet its obligations to beneficiaries. An effective risk management framework would ordinarily assist an RSE licensee to mitigate the risk-taking incentives provided by remuneration systems and remain within its risk tolerance.
33. SPS 510 requires that, in rewarding individual performance, the Remuneration Policy be designed to encourage behaviour that supports the risk management framework of the RSE licensee. In designing remuneration arrangements, APRA expects the Board Remuneration Committee will consider, among other matters:
 - (a) the balance between fixed (salary) and variable (performance-based) components of remuneration. Performance-based components include all short-term and longer-term incentive remuneration, payable with or without deferral; and
 - (b) whether cash or equity-related payments are used and, in each case, the terms of the entitlements including vesting and deferral arrangements.
34. APRA expects the level of performance-based remuneration to reflect the levels of risk to which the RSE licensee is exposed by an individual in performing their role. For example, it would not be prudent practice to remunerate in the same manner two employees who generate the same net return to members but assume different amounts of risk on behalf of the RSE licensee. A prudent policy will require that performance-based remuneration is low, perhaps zero, where the individual has been found to have exposed the institution to risk beyond its risk appetite or controls.

Fixed and variable remuneration components

35. A prudent overall remuneration structure, including the balance and selection of components of remuneration, would promote a culture and working environment that attracts and encourages staff who fit an RSE licensee's risk appetite.
36. One aspect to consider in the design of the remuneration structure is the balance between base (or fixed) pay and performance-based (or variable) components. Components of base pay are usually base salary, superannuation and retirement benefits, and perhaps reimbursement of some kinds of expenses.
37. It is desirable that base pay comprise a sufficient proportion of total remuneration to enable the Board to make performance-based components genuinely discretionary. Boards will need to seek a balance in their Remuneration Policy between offering incentives for good performance and avoiding incentives for an individual to take risks that are outside the RSE licensee's risk appetite.

Adjusting financial performance measures for risk

38. At the product or portfolio level, prudent decisions generally correspond to sound business practices aimed at enhancing the value of the product or portfolio from year to year. Similarly, at the corporate level, prudent decisions generally correspond to business plans and corporate initiatives that are aimed at generating net returns to members in accordance with the investment strategy or enhancing the value of the business from year to year.
39. SPS 510 requires risk adjustment, but precision is not intended. At the simplest level, risk adjustment could be achieved by categorising business undertaken as higher or lower risk. Risk adjustment could also include non-financial measures of risk, such as compliance or internal audit scores for the period under consideration.
40. It is important for an RSE licensee to recognise and adjust remuneration for non-financial measures, such as compliance with risk management and internal audit frameworks, management of staff, adherence to corporate

values and displaying acceptable corporate citizenship. Performance against risk-related non-financial measures may be identified through various mechanisms. These include internal or external audit findings, risk management assessments including any compliance breaches, unexpected taxation or litigation consequences, or administrative, civil or criminal actions taken against the RSE licensee. Adverse performance by an individual in these areas would be expected to be reflected in reductions to, or elimination of, any current or deferred performance-based remuneration.

41. SPS 510 requires that the design of remuneration arrangements take account of the risks in an RSE licensee's business operations and the time needed for outcomes of those business operations to be adequately measured. It would be prudent practice for a substantial portion and preferably a majority of performance-based remuneration to be deferred and at risk for an extended period. Such remuneration would therefore be exposed to potential reduction or elimination until performance is suitably validated with time.

Dealing with extreme outcomes

42. Performance-based remuneration arrangements are commonly structured to recognise individual performance and contributions to results at both the business unit level and for the whole of the RSE licensee's business operations.
43. There can be a conflict between rewarding individuals and business units that perform well when an RSE, or a relevant large business unit within the business operations of the RSE licensee, fails to perform well. The Remuneration Policy needs to be structured in a manner that defines in advance how the RSE licensee will respond to uneven performance across the RSE licensee's business operations, including circumstances where the RSE licensee's business operations face material adversity.
44. Where unexpected or unintended adverse outcomes arise during any deferral period, SPS 510 requires that the Remuneration Policy

provide for and enable the Board to adjust downwards and, where appropriate, eliminate payment of performance-based remuneration for two reasons. One is to protect the financial position of the RSE licensee's business operations or its ability to meet the reasonable expectations of beneficiaries in adverse circumstances. The other reason is broader and is for circumstances where material unexpected outcomes arise. These could include material risk management breaches, unexpected financial losses to the RSE licensee's business operations, reputational damage or regulatory non-compliance. In addition, APRA expects the Board to retain discretion to modify unwarranted remuneration flowing from extreme formula-based bonus calculations. Both of these discretions are intended to cater for extreme circumstances. The exercise of such discretion needs to be contractually permitted.

Other considerations for executive remuneration

45. Executives are often able to make decisions that materially influence the long-term financial position of the RSE licensee's business operations or its ability to meet the reasonable expectations of beneficiaries. Accordingly, it is sound practice to structure the components of performance-based remuneration in a way that aligns financial incentives for these executives with long-term, successful stewardship of the RSE licensee.

Equity-related components

46. Where remuneration arrangements include equity-related components, an RSE licensee would be expected to refer to relevant guidance in PPG 511.

Incoming and terminating payments

47. APRA considers that the balance between ensuring sound remuneration practices across an RSE licensee's business operations, compared

with the incremental ability to attract or remove individual employees, can only prudently be resolved in favour of sound remuneration practices across the whole RSE licensee. APRA recognises that competition in recruiting may encourage an RSE licensee to provide cash payments or cash bonuses to incoming staff. Conversely, the desire to part with an under-performing or redundant executive may lead to the desire to 'cash out' such a departure. APRA nevertheless expects an RSE licensee to place suitable deferral and performance hurdles on incoming and termination payments.

48. Guaranteed or up-front cash payments beyond normal remuneration for incoming executives or other staff ('golden handshakes') are generally inconsistent with prudent remuneration practice as they generally do not align with the principles of risk adjustment and deferral until performance is validated. Also, such payments restrict the ability of an RSE licensee to reduce 'at risk' remuneration upon material adverse outcomes eventuating. APRA expects any remuneration paid to incoming staff as compensation for deferred remuneration forfeited at a previous employer to be subject to performance validation or risk adjustment and deferral.
49. Accelerated or unusually large payments to terminating executives, such as 'golden parachute' cash payout arrangements, are generally inconsistent with prudent practice and may expose an RSE licensee to considerable risk. They pose a particular risk in the context of potential mergers of RSEs and the conflict between assessment of the merits of a merger with potential receipt of a termination payment by a director or responsible person. Prudent RSE licensees will carefully review any such existing or proposed arrangements and their potential impact on the financial position of the RSE licensee's business operations or its ability to meet the reasonable expectations of beneficiaries.



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